

Strategies for Managing your Assets and Liabilities

California Debt and Investment Advisory Commission
California Bond Buyer Pre-conference Program

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Charles Schwab Investment Management, Inc. (CSIM)
CSIM is a division of Charles Schwab & Co., Inc, Member SIPC.

Charles Schwab Investment Management

Charles Schwab Investment Management (CSIM)

- Investment advisor for Schwab Funds and Laudus Funds.
- Schwab Funds reported \$136.7 billion in assets under management at March 31, 2005 and 5.4 million shareholder accounts.

Schwab Funds

- Over \$24 billion in municipal money fund assets.
- The nation's largest California state-specific money fund, with \$7 billion assets at June 30, 2005.

Money funds are some of the largest buyers of short-term and variable rate debt

- In municipal market, eligible investment alternatives are limited – both by the nature of the municipal debt markets and by money fund regulation.

Investor Demand for Short-Term and Variable Rate Debt

Why variable rate debt?

- Issuance of short-term and variable rate debt may broaden your investor base.

Money market funds totaled \$1.9 billion at December 31, 2004 (Source: ICI)

- \$310 billion in tax-exempt funds.

How robust is demand for shorter-term paper?

- Witness the Growth in tender option bonds (TOB) programs: S&P alone reported a 15% increase in TOB ratings' volume in 2004 over 2003 totaling \$15 billion.
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Investor Demand for Short-Term and Variable Rate Debt

These instruments also important components of bond funds

- Liquidity for potential fund redemptions
- Allow for future investment opportunities
- Typically far smaller share of those portfolios than in a money fund

Short-Term/VR debt instruments take many forms

- Commercial paper, short-term cash flow and bond anticipation notes, variable-rate demand notes, put bonds, TOBs, and auction rate securities
- Not all are eligible for purchase into money fund portfolios

Helpful to know something about the rules that govern money market fund investing.

- Fund analysts review many of the same credit factors as colleagues at the rating agencies
- Money funds must review additional regulatory factors

Money Market Funds: A Few Key Factors

Money market funds governed by Rule 2a-7 of the Investment Company Act of 1940

- Designed to help the funds maintain a stable share price.

Rule 2a-7 imposes limits for credit quality, diversification, and maturity

- High quality “eligible securities” only
 - Exposure to most issuers limited to 5% of assets
 - Maturity limits on both individual securities and of the overall weighted average portfolio.
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Money Market Funds: A Few Key Factors

Credit quality

- May invest only in “eligible securities”. With exceptions, the rule limits purchases to securities rated in the top two short-term rating categories by Moody’s, S&P and Fitch, or if unrated, that are of comparable quality
- Overwhelming majority must be “First Tier” securities – rated in the top short-term rating category by these agencies (P-1, A-1 or A-1+, and F1 or F1+), or if unrated, of comparable quality
- The fund’s Board of Directors or its designee, the investment advisor (e.g., CSIM) has to independently determine that the security presents “minimal credit risk”.
- **Thus, the fund must make its own evaluation of credit quality.**

Money Market Funds: A Few Key Factors

Diversification

- Requirements vary: taxable or a tax-exempt national or state specific funds
 - Substantially limit investment in the securities of most issuers to no more than 5% of the total portfolio assets. (For single state municipal funds, this 5% limitation applies to 75% of its total assets.)
 - Rule allows for greater concentration for securities that are fully guaranteed by entities that are not controlled by the issuer (e.g., bond insured, letter of credit enhanced).
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Money Market Funds: A Few Key Factors

Maturity

- Rule 2a-7 limits the dollar-weighted average portfolio maturity to 90 days
 - Individual securities must have remaining maturity of 397 calendar days or less (i.e., 13 months)
 - Some securities that may have a nominal maturity date that is significantly longer than 397 days may nonetheless be eligible securities under certain circumstances. Bonds that are subject to a demand feature (such as variable rate demand obligations), can be “deemed” to mature on the date in which the principal amount must be paid.
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Securities Enhanced by LOC

LOC terms and coverage

- Expiration and provisions for extension
- Principal and interest coverage
- Terms of reinstatement
- Multiple credit providers: fractional or layered credit support

LOC substitution

- Requirements and timing
- Notification with or without mandatory tender

LOC enhanced commercial paper

- Ideally the same standard as for VRDOs

Securities with Conditional Demand Features

Liquidity Coverage

- Expiration and provisions for extension
- Principal and interest coverage
- Terms of reinstatement
- Multiple credit providers: fractional or layered liquidity

Liquidity substitution

- Requirements and timing
- Notification with or without mandatory tender

Liquidity termination events

- Remote and/or monitorable (see continuing disclosure)
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Continuing Disclosure: Rule 15c2-12

Rule 15c2-12 of the Securities and Exchange Act of 1934

- Governs the municipal market's disclosure obligations
- In general, prohibits a broker or dealer from buying or selling municipal securities unless they have reasonably determined that the issuer or the “obligated person” under the securities has undertaken to provide certain annual information and event notices to recognized information depositories.

Specific exemption for certain short-term securities

- Exempts securities maturing in < 9 months
- Exempts securities that, at holder's option, can be tendered back for purchase or redemption at par value at least as frequently as every 9 months (i.e., most VRDOs).

Continuing Disclosure

Rule 15c2-12 obligations are a minimum standard

- Issuers may voluntarily disclose more information than required by the Rule
- Additional disclosure burden should be minimal, if disclosing on similar “non-exempt” securities
- If no similar securities, voluntary disclosure will increase marketability of your debt

National Federation of Municipal Analysts’ “Recommended Best Practices in Disclosure for Variable Rate and Short-Term Securities”

- Paper published February 2003
- Developed by analysts in conjunction with non-analyst professionals, including GFOA
- To promote timely and complete disclosure of information needed to assess credit quality
- Paper available at www.nfma.org

Continuing Disclosure

- **Credit risk must be reviewed on an ongoing basis to assure that securities continue to present “minimal credit risk”**
 - Rule 2a-7 requires that money funds be in a position to monitor the continuing eligibility of the securities held by the fund
 - If a security ceases to present minimal credit risk, that security is no longer an “eligible security” and may have to be sold
 - Changes in structural characteristics, such a change in credit enhancer or liquidity provider, must be disclosed as soon as possible. The fund must conclude that the issuer has undertaken to provide notice in the event of credit substitution or liquidity substitution.

Continuing Disclosure

Substitution of credit facilities

- Rating maintenance is helpful, but insufficient
- Other considerations, such as the fund's portfolio diversification and/or our own evaluation of that substitute credit enhancer's creditworthiness will be factors in determining whether we can continue holding the security.

Securities with conditional demand features

- Liquidity is typically conditioned upon maintenance of the principle credit source's investment grade credit quality
- We have to be in a position to determine that the conditions are monitorable
- Your bonds will have better marketability if we can easily accomplish that task